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PORT COMMISSION:

The Port Inappropriately
Administered Its Leases With
Affordable Self Storage, Inc.

FINANCIAL AUDITS
DIVISION



July 21, 2005

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CITY AND COUNTY OF SAN FRANCISCO

OFFICE OF THE CONTROLLER
FINANCIAL AUDITS DIVISION

Ed Harrington
Controller

Monique Zmuda
Deputy Controller

July 21, 2005

Audit Number 04022

Port Commission
Pier One
San Francisco, CA 94111

President and Members:

The Office of the Controller presents its report concerning the audit of Affordable Self Storage, Inc. (Affordable). The Port of San Francisco (Port), acting under the authority of the Port Commission, had two leases with Affordable to operate a mini storage facility on Port property at 20th Street and Illinois Street in San Francisco. The terms of both leases ended on February 28, 2005. Affordable continues to operate the mini storage facility on a month-to-month basis.

Reporting Period: March 1, 2000, through February 28, 2005


Rent Paid: \$1,145,659

Results:

- The Port incorrectly applied annual cost of living rent increases for one of its leases with Affordable and subsequently under-billed Affordable for rent. As a result, Affordable underpaid its rent to the Port by \$37,660 for the five-year period reviewed.
- The Port improperly issued \$73,602 in rent credits to reimburse Affordable for repaving and re-fencing the leased property and for delaying commencement of monthly rent payments for one lease for four months.
- By concurrently entering into separate leases for one location, the Port circumvented the San Francisco City Charter section that requires Board approval for all leases expected to garner \$1,000,000 or more in rent during the lease term.

The Port's response is attached to this report. The Controller's Financial Audits Division will be working with the Port to monitor the status of the recommendations made in the report.

Respectfully submitted,


Noriaki Hirasuna
Director

INTRODUCTION

BACKGROUND

Affordable Self Storage, Inc. (Affordable) entered two leases in 2000 with the Port of San Francisco (Port), acting under the authority of the San Francisco Port Commission, to operate a mini storage facility on Port property at the southeast corner of the intersection of 20th Street and Illinois Street in San Francisco. The leases state that the mini storage facility is to consist of the temporary placement of storage containers, temporary administrative offices, tenant and invitee parking, and the sale of packing and storage materials.

Under two separate leases, Affordable rented the paved yard on which the mini storage facility is located. Part of the yard is rented under lease number L-12867 (first lease), and the remainder is rented under lease number L-12871 (second lease). The area rented under the first lease is comprised of two contiguous sections with a different rent commencement date specified for each: March 1, 2000, for one section and June 1, 2000, for the other. The term for the second lease commenced on September 1, 2000. Both of the lease terms ended on February 28, 2005, and Affordable continues to operate the mini storage facility, under the terms of both leases, on a month-to-month basis.

The leases require Affordable to pay specified monthly rents to the Port. During the audit period, the monthly rent amounts for the first lease ranged from \$5,794 to \$14,577, while those for the second lease ranged from \$6,950 to \$7,601.

SCOPE AND METHODOLOGY

The purpose of this audit was to determine if Affordable complied with the rental payment provisions of its leases with the Port for the period from March 1, 2000, through February 28, 2005.

To conduct the audit, we reviewed the applicable terms of the leases and verified the amount of rent paid to the Port by Affordable for both leases. We also interviewed Port personnel regarding lease administration matters, including the implementation of rent increases specified in the leases, and performed other tests we considered necessary.

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AUDIT RESULTS

THE PORT UNDER-BILLED AFFORDABLE FOR RENT BECAUSE THE PORT'S REAL ESTATE STAFF INCORRECTLY APPLIED LEASE TERMS

From March 1, 2000, through February 28, 2005, Affordable Self Storage, Inc. paid \$1,145,659 in rent to the Port for operating a mini storage facility at 20th Street and Illinois Street¹. However, the Port incorrectly applied some of the terms of lease number L-12867 (first lease), and incorrectly calculated increases in rent. As a result, Affordable underpaid its rent to the Port by \$37,660.

The under-billing occurred because the Port's real estate staff incorrectly adjusted the base rent amounts. The leases require the base rents to be adjusted annually in proportion to the percentage increase in the U.S. Department of Labor, Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers, San Francisco-Oakland-San Jose, California (CPI). However, for the first lease, we found that the amounts of the annual CPI rent increases applied by the Port, and paid by Affordable, were less than the increases required by the terms of the lease. In calculating the annual increases for this lease, the Port incorrectly used the January 2001 CPI of 184.1² as the base CPI, instead of the January 2000 CPI of 174.5² as required by the lease. We found that the Port's initial calculation of the first annual rent increase was correct, the details of which were documented in the notification letter sent to Affordable and signed by the Port property manager responsible for managing the leases. However, the Port property manager revised the base CPI and subsequently sent notification letters that used the incorrect base CPI for annual adjustments. Affordable underpaid its rent to the Port by \$37,660 as a result.

We interviewed Port staff regarding the reasons for the incorrect application of the lease terms. According to the Port property manager responsible for managing the leases, a Port management

¹ Affordable also paid the Port \$197,845 under the terms of monthly licenses entered into for the months of April 2004 through February 2005. These licenses were for the rental of open space at Sea Wall Lot 356 near 26th Street and Delaware Street in San Francisco. We did not include these licenses in the scope of this audit.

² Since no January CPIs are published, then the CPI for the immediately preceding month of December was used, as required by the lease.

assistant had found that a number of CPI rent changes were wrong, and the management assistant had therefore corrected the initial calculation for this lease. The property manager further stated that he did not know why the original calculation was incorrect, nor did he know the reason for the correction.

However, according to the Port management assistant, the property manager made the decision to revise the CPI calculation. The management assistant stated that he makes such changes only when instructed to do so by the property managers. In this case, he stated that he was informed by the property manager that the base CPI needed to be changed because the property manager felt that Affordable should not have to pay for an increase based on a January 2000 base index. The management assistant stated that the reason given by the property manager was that there were some problems with flooding, so that Affordable could not properly occupy the premises until January 2001.

Since the property manager and management assistant each stated that the other was responsible for changing the base CPI, we notified the property manager about the statement made by the management assistant, and asked the property manager to clarify who initiated and approved the change to the base CPI. The property manager, however, chose not to respond to our inquiry. Under Port procedures, property managers are responsible for ensuring that lease terms are properly applied. We therefore conclude that the property manager is responsible for the incorrect application of lease terms that improperly provided financial benefit to Affordable, and that he failed to explain his actions.

THE PORT IMPROPERLY ISSUED SOME RENT CREDITS TO AFFORDABLE

Port real estate staff improperly issued \$73,602 in rent credits to Affordable to delay the commencement of monthly rent payments for one of the leases, and also to reimburse Affordable for repaving and other expenses for both leases. However, the leases contain no provisions for issuing these rent credits. The Port acted improperly by granting the credits without modifying the leases. The table on the next page shows the rent credits, as well as the rent Affordable paid to the Port.

TABLE

**Affordable Self Storage, Inc.
Rent Paid and Credits Improperly Applied
March 1, 2000, Through February 28, 2005**

Period	Rent Paid (Net of Credits Issued)	Credits Improperly Applied*
Lease number L-12867		
March 1, 2000, through December 31, 2000	\$ 86,942	\$25,269
January 1, 2001, through December 31, 2001	157,890	7,465
January 1, 2002, through December 31, 2002	168,419	0
January 1, 2003, through December 31, 2003	173,679	0
January 1, 2004, through December 31, 2004	174,862	0
January 1, 2005, through February 28, 2005	<u>29,153</u>	<u>0</u>
Sub-total	790,945	32,734
Lease number L-12871		
September 1, 2000, through December 31, 2000	\$ 0	\$27,800
January 1, 2001, through December 31, 2001	71,746	13,068
January 1, 2002, through December 31, 2002	88,051	0
January 1, 2003, through December 31, 2003	89,244	0
January 1, 2004, through December 31, 2004	90,472	0
January 1, 2005, through February 28, 2005	<u>15,201</u>	<u>0</u>
Sub-total	354,714	40,868
Total	\$1,145,659	\$73,602

* The credits listed do not include other credits we found to be properly issued, for example, those issued to correct billing errors. We also did not include credits of less than \$10.

The Port Improperly Issued Rent Credits to Delay the Commencement of Rent Payments

The Port improperly issued rent credits of \$27,800 to delay the commencement of monthly rent payments for the second lease until January 2001. The Port issued \$6,950 in credits for each month from September 2000 through December 2000. However, this was contrary to the terms of the second lease, which required Affordable to pay monthly rent of \$6,950 starting in September 1, 2000.

Port records state that the credits were issued because the Port needed to prepare the premises for use. According to the Port property manager responsible for managing the lease, no rent was paid for the second lease until January 2001 because part of the premises needed repaving before it was ready for the tenant to move in. In addition, the Port property manager who prepared the leases stated that there was no lease amendment to change the rent commencement date because there was no desire on the part of the tenant to change the commencement date. The property manager also stated that the credits were approved by the Port real estate director at that time. The Port subsequently reimbursed Affordable for hiring a third party contractor to repave the premises³. However, since the second lease was signed by the tenant in December 1999 and executed by the Port's acting real estate director in April 2000, the Port had sufficient time to either properly amend the lease rent commencement date, or to take steps to ensure that the Port could deliver the premises in good and serviceable condition, as required by the lease, by September 2000.

The Port Improperly Issued Rent Credits for Repaving and Other Work

The Port improperly issued rent credits of \$45,802 to reimburse Affordable for repaving and other work performed on the premises. Port records show that \$38,337 of the rent credits was issued to reimburse Affordable for repaving, with the remaining \$7,465 for replacement of fencing, to install a slide-gate and to pay for an electric gate opener⁴. The records also show that the credits were issued for work carried out on portions of the premises covered by both leases. In issuing these credits, the Port failed to adhere to relevant provisions in Affordable's leases stating that the Port shall not be obligated to make any repairs, replacement or renewals whatsoever to the premises, nor to any improvements or alterations.

We also found that, by permitting Affordable to contract with third parties to perform basic construction work, such as repaving, and then reimbursing Affordable for such work through the issuance of rent credits, the Port did not ensure that this work was performed as economically as possible and in compliance with City policies

³ We did not determine the date that Affordable started using the section of the yard under the second lease, nor did we determine when the premises were actually repaved by the contractor.

⁴ We did not test the veracity of Affordable's expense claims, or the reasonableness of the actual charges, for the improvement credits.

and procedures. For example, the City and County of San Francisco's Public Works Contracting Policies and Procedures, as detailed by Chapter 6 of the San Francisco Administrative Code, governs public works or improvements contracting policies and procedures⁵.

Chapter 6 specifies a number of requirements for work performed under contract that is estimated to cost \$100,000 or less. For example, it requires departments to obtain no fewer than three quotes and to award the contract to the responsible bidder offering the lowest quotation. Chapter 6 also requires the department administering the contract to maintain records as to whom the request for quotations was directed and the quotations received. In addition, Chapter 6 specifies minimum terms and conditions to be included in all construction contracts awarded by the City, for example with regards to prevailing wages, local hiring and indemnification. We concluded that Port management should have consulted with the Office of the City Attorney regarding whether its practices complied with relevant Administrative Code provisions.

THE PORT DID NOT OBTAIN REQUIRED APPROVAL FOR THE LEASES AND THE PORT'S LEASING POLICY IS NOT CONSISTENT WITH THE SAN FRANCISCO CHARTER

The Port entered two separate leases with Affordable Self Storage, Inc. to rent three sections that comprise the paved yard at 20th Street and Illinois Street. Two sections of the yard were rented under lease L-12867 while the remaining section was rented under the lease L-12871⁶. However, by entering into separate leases for one location, the Port circumvented the San Francisco Charter (charter) provision that requires the approval of the Board of Supervisors (board) for all leases with anticipated revenue of \$1,000,000 or more during the lease term, or which have a term of ten or more years.

⁵ Chapter 6 empowers the Port to contract for such works, and allows the department head, in this case the Port's executive director, to award any construction contract of less than or equal to \$100,000 without the approval of the mayor, commission or board concerned.

⁶ The leases were signed concurrently by Affordable in December 1999. The Port's acting director of real estate signed the first lease in January 2000 and the second lease in April 2000. The leases have identical terms, except for the commencement dates, base rent amounts, and sections of the yard rented.

Separately, neither of the two leases required board approval since each had terms of less than ten years, and each had anticipated rent of less than \$1,000,000 over its term. However, the total expected rent payments for both leases taken together, not including annual cost of living adjustments, would be \$1,164,861, which would require board approval. According to the Port property manager who prepared the leases, the Port entered into two leases because Affordable's principals wanted to grow into the business, and the Port's willingness to work with the tenant was to the Port's advantage because it enhanced the Port's chances of increasing revenues. However, we do not find this to be a reasonable explanation for entering two separate leases for renting the paved yard, and consequently not requesting board approval as required by the charter. Since the Port rented the first two sections of the yard, with two different commencement dates, under the terms of the first lease, we found that the Port should have included the third remaining section of the yard, with its own separate commencement date, in this lease. To ensure compliance with the charter, the Port should have requested board approval of this lease.

We also found that the Port's leasing policy is not fully consistent with charter requirements, in that there are instances in which the charter requires board approval of a lease, but the Port's leasing policy does not require Port Commission (commission) approval. In this case, the charter requires board approval of the leases because the total expected rent payments were greater than \$1,000,000 over the term of the leases. However, since the rent due was within a specified range of monthly rent per square foot, the Port's leasing policy allowed the Port's executive director to approve and execute the leases on behalf of the Port without approval by the commission. The Port's leasing policy should, at a minimum, require commission approval in all cases in which board approval is required.

RECOMMENDATIONS

To ensure that the Port receives all the rent it is due from Affordable Self Storage, Inc., and that the Port properly manages its leases with Affordable, the Port should take the following actions:

- Bill and collect \$37,660 from Affordable in additional rent, owed as a result of the Port's incorrectly adjusting the annual base rents and under-billing Affordable for rent under the terms

of lease number L-12867. In addition, since the actions improperly provided financial benefit to Affordable, the Port should take appropriate measures to prevent a recurrence of these actions.

- Bill and collect \$73,603 from Affordable to recover the rent credits improperly issued during the audit period, or modify the leases to allow for the granting of the credits. If the Port chooses to modify the leases, it should obtain all approvals required by the San Francisco Charter.
- Draft a formal policy governing the issuance of rent credits for construction and other work. This policy should preclude the Port Real Estate Division from making agreements with tenants to pay for such work outside of lease terms.
- Consult with the Office of the City Attorney regarding whether the practice of paying for construction and other work by providing rent credits, instead of contracting directly for the work, complies with relevant Administrative Code provisions.
- Instruct its staff to ensure that all leases, and any subsequent amendments or modifications, receive Board of Supervisors approval when required by the San Francisco Charter, and take appropriate actions to prevent the practice of circumventing this requirement. In addition, if the Port continues to lease the premises to Affordable under the terms of the current two leases, the Port should seek board approval for doing so.
- Take appropriate corrective and disciplinary personnel actions, as considered necessary, to address the issues outlined in this report and to prevent recurrences.
- Review and revise the Port's leasing policy so that Port Commission approval is required for any leases with expected revenues of \$1,000,000 or more, or which have a term of 10 years or more, consistent with San Francisco Charter requirements for board approval of leases.

We conducted this review according to the standards established by the Institute of Internal Auditors. We limited our review to those areas specified in the audit scope section of this report.

Staff: Robert Tarsia, Audit Manager
Kathy Buckley

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PORT OF SAN FRANCISCO RESPONSE TO THE AUDIT



July 15, 2005

Mr. Noriaki Hirasuna
Controller's Financial Audits Division
1 Dr. Carlton B. Goodlett Place, Room 388
San Francisco, California 94102-4694

Dear Mr. Hirasuna:

Thank you for the opportunity to comment on the findings and recommendations set forth in the Controller's Audits Division report resulting from the financial audit of the Port's two leases with Affordable Storage, Inc (Affordable). The report identifies errors in the administration of these leases which require corrective action by the Port.

As noted in the report, both of the leases originated in 1999 and the lease terms ended on February 28, 2005. Affordable continues to operate its mini storage facility on the premises on a month-to-month basis. Port intends to put these premises out to bid later in 2005 and will terminate these leases.

Most of the findings cited in the report emanate from approved decisions made at inception and during the first year or so of the leases. The executive professionals who approved the leases and transactions at issue are no longer with the Port. There are items that clearly require current follow-up action. Review and investigation by current management of the matters cited in the audit is in progress. Final corrective actions will be determined after we complete our full review. The following are our preliminary comments pertaining to the audit findings and recommendations:

Lease Approval Process

The Port is cognizant of Section 9.118 c of the San Francisco City Charter, which requires any lease of real property having anticipated revenue of one million dollars or more be approved by the Board of Supervisors. Based on the audit finding and our own review of the documents for the Affordable leases, it is clear that two separate leases were concurrently executed by the tenant on the same day, but signed by different Real Estate Directors four months apart. The Director for Real Estate and Deputy City Attorney that approved and executed these leases are no longer with the Port. Splitting transactions to circumvent any review requirement is not condoned and current management will increase controls to prevent such action.

As a matter of standard operating protocol, Port staff usually obtains Port Commission approval prior to seeking any required Board approval. The audit report pointed out that because the Affordable leases met the Commission's pre-approved rental parameters, the leases were allowed to be executed by the Port staff, without the specific approval of the Commission. We will edit the Port's leasing policy to overtly indicate that the Port Commission must first approve any lease for which Board approval is also required. Independent of this audit, current management has been reviewing the Port's internal policies and procedures for leasing and expects Port Commission review and approval of a Port Leasing Procedure Policy by mid-September 2005.

Rent Credit Policy

Prior to 2003, the Port operated under a rent credit policy for certain capital improvements or repairs that was adopted by the Port Commission in 1991. Through Resolution No.03-54, the Port Commission

rescinded this former policy, as well as any delegated discretionary authority assumed by the Executive Director or Port staff. With the adoption of this resolution on July 16, 2003, rent credits, like those issued to Affordable in 2000 and 2001, require the Port Commission's specific approval in the lease agreement. Rent credits must now be considered by the Port Commission on a case-by-case basis and any new lease agreement or amendment to an existing lease agreement containing a provision for rent credits must be presented to the Port Commission for approval. Port staff has never had authority to make agreements with tenants to pay for work outside of specific lease provisions. Any future rent credit policy will contain an overt statement to reinforce this point.

We are consulting with the Office of the City Attorney as to whether Administrative Code provisions governing public works projects were intended to govern the practice of granting rent credits for tenant funded improvements to leasehold premises, in lieu of charging a lower lease rent for property lacking in those improvements. We will notify you of the findings after they complete their review and respond to us.

Financial Findings

Section 1.9 of the leases indicated that the Port committed to delivering the premises to Affordable in "good and serviceable condition and repair." Port Real Estate staff did not or was not able to schedule the site preparation work with Port Maintenance prior to the lease commencement dates. Affordable proceeded with repaving and preparing the lots for its use and Port Real Estate agreed to reimburse Affordable for these costs through rent credits (\$45,802). Port Real Estate also agreed to delay the rental commencement date (\$27,802 in billing reversals) and reset the CPI index date of one lease without formally modifying the agreement (\$37,660 in CPI rental adjustments not billed).

The City Attorney's Office advises that because of the statute of limitations on the foregoing, it is unlikely that the Port can legally enforce a claim against Affordable at this time. The following are additional corrective measures or improvements that we have implemented or intend to implement:

- Direct staff to not allow early entry in those circumstances where premises are not properly prepared for intended use or acceptable for occupancy in accordance with agreement terms (i.e. no early entry outside of specific lease provisions).
- Instruct staff to ensure that all leases receive Board of Supervisors approval when and as required by the San Francisco Charter.
- Incorporate check-off for Board of Supervisor action and resolution number on internal "blue sheet" ("Basic Lease Terms"), in addition to existing check-off for Commission action.

Please contact me at contact me at (415) 274-0401 if you have any questions or require more information.

Sincerely yours,



Monique Moyer
Executive Director

cc: Marian Saez, Director of Real Estate
Tina Olson, Director of Finance & Administration
John Woo, Fiscal Officer

cc: Mayor
Board of Supervisors
Civil Grand Jury
Public Library

